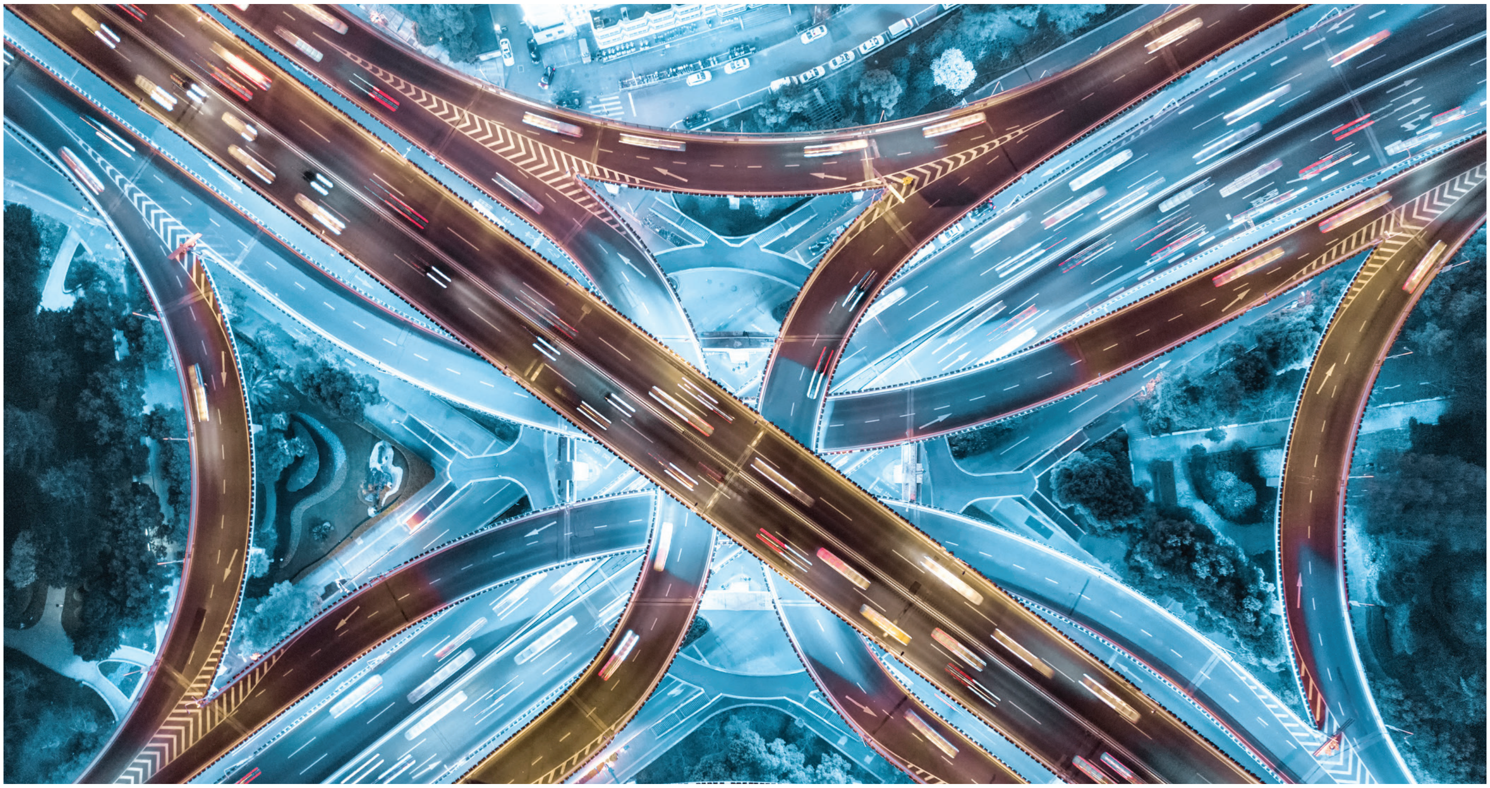
MARKET INSIGHTS

The investment outlook for 2020

Investment strategies for a late-cycle environment



IN BRIEF

- The U.S. economy has returned to slower growth, but should avoid recession in 2020.
- Overseas economies should see modest improvement as trade tensions ease.
- The Fed may leave rates unchanged in 2020, but other central banks are still in easing mode.
- Modest U.S. equity gains should be built on somewhat higher earnings rather than multiple expansion.
- International equities should outperform in the long run, but will be challenged for as long as trade tensions persist.
- Market volatility could be higher in an election year. Investors will need to be well diversified and should avoid letting how they feel about politics govern how they think about investing.

J.P.Morgan
Asset Management

INTRODUCTION

American football is, in its essence, a simple game. One side tries to maneuver the football down the field into the opponent's end zone and the opponent tries to stop them from doing so. However, the strategy employed differs depending on where you are in the game. Early on, aggression is the keyword on both sides of the ball, as each team is willing to take risks to put points on the board. But later on, particularly when one team has racked up a lead, the tactics change. The leading team will run more and throw less on offense. On defense, instead of trying to sack the quarterback, you double-team the wide receivers and are willing to give up short yardage to avoid a long play against you.

How you should play the game depends upon *where* you are in the game.

Investors thinking about 2020 and beyond face similar strategic issues. Those who have participated in an almost 11-year bull market in stocks and a more than 38-year bull market in bonds have racked up substantial gains. However, starting from this point, considering both the current position of the U.S. economy and current valuations, returns should be lower and some more defensive strategies may need to be employed.

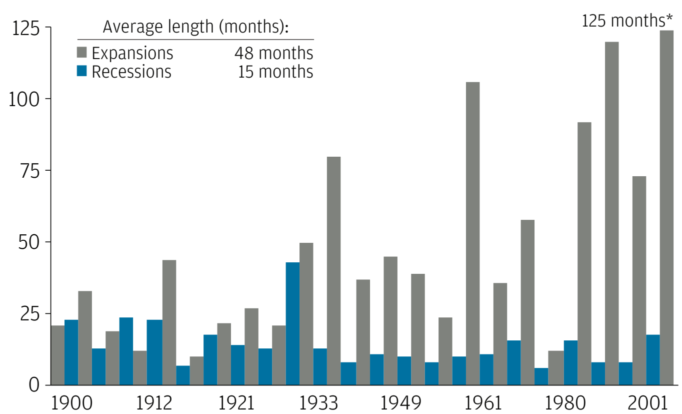
Having said this, we expect both the U.S. economy and the global economy to grow in 2020, with decelerating growth in the U.S. and faster growth overseas. With inflation and interest rates still very low, there should be potential for gains in equities in both the U.S. and overseas. Fixed income returns will be modest regardless of whether the next year brings small increases or decreases in long-term interest rates. Meanwhile, investors will need to adhere to fundamental investing principles both to control risk in a potentially more volatile environment and to take advantage of opportunities in recently less favored areas such as emerging market (EM) equities.

U.S. ECONOMY: STEADY GROWTH FOLLOWING A SOFT LANDING

In 2020, the U.S. economic expansion should enter its 12th year, having successfully downshifted from 3% growth to 2% growth without falling into recession. The remarkable longevity of the expansion and a continuation of low inflation and unemployment are all significant positives. However, from an investment perspective, the outlook is far from ideal. Slow economic growth and rising wages will put pressure on margins while steady inflation should preclude a significant bond market rally. In addition, long-term returns will be challenged by the implications of a growing budget deficit and political risks of greater protectionism or higher taxation will continue to give investors plenty to worry about.

The longest U.S. economic expansion should continue in 2020

EXHIBIT 1: LENGTH OF EXPANSIONS AND RECESSIONS IN MONTHS



Source: National Bureau of Economic Research, J.P. Morgan Asset Management. *Chart assumes current expansion started in July 2009 and continued through November 2019, lasting 125 months so far.

Data are as of November 26, 2019.

The strongest part of the U.S. economy should continue to be consumer spending. Even as the lift from the 2017 tax cuts fades, household spending will be supported by good gains in wages. Over the course of 2020, we expect real disposable income to climb by roughly 2.0%, as wages continue to outpace inflation and payrolls gradually expand. Investment spending, however, will remain sluggish as businesses deal with uncertainty from ongoing trade tensions and a slow-growing global economy. In addition, inventories should grow more slowly, dragging on GDP growth, while trade and government spending should have more neutral effects.

On balance, we believe the U.S. economy will avoid recession in 2020. The greatest risk of a downturn centers around the possibility that businesses might collectively freeze or reduce hiring, given trade uncertainty and a slow-growth outlook.

However, this is probably not quite enough to cause a recession and the historically most potent recession triggers appear less dangerous at this time.

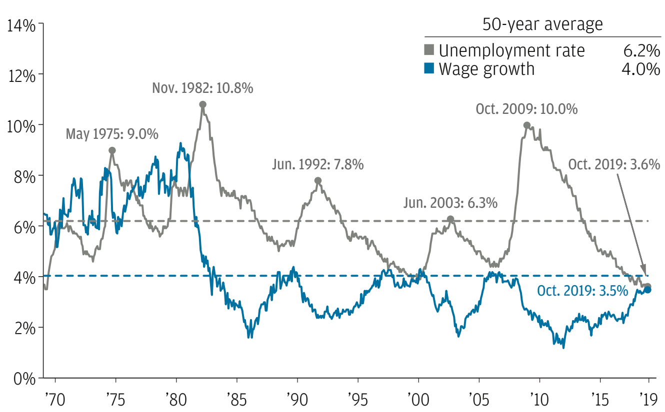
First, long-term interest rates are unusually low for this late in an expansion. This means that neither businesses nor consumers are getting boxed out of big-ticket spending decisions because of high financing costs.

Second, the most cyclical sectors of the economy are subdued with no boom in housing, autos or capital spending. This reduces the risk of a "boom-bust" cycle pushing the economy into recession.

That being said, slow economic growth should translate into slow employment growth, with monthly job gains of roughly 130,000 in 2020 compared to 170,000 in 2019 and over 220,000 in 2018. Very low labor force growth implies that even this reduced pace of job growth should be consistent with a gradual tightening of the labor market, with the unemployment rate falling to 3.3% in the fourth quarter of 2020 from 3.5% a year earlier. Despite this, wage growth will likely remain steady at between 3.0% and 3.5% year-over-year, as the pressure of tightening labor markets meets a concerted corporate effort to maintain margins.

Both the unemployment rate and wage growth should be steady in 2020

EXHIBIT 2: CIVILIAN UNEMPLOYMENT RATE AND YEAR-OVER-YEAR GROWTH IN AVERAGE HOURLY EARNINGS, PERCENT



Source: Bureau of Labor Statistics, J.P. Morgan Asset Management.

Data are as of November 26, 2019.

All of this should result in low and steady inflation, with the core consumption deflator gradually moving up to a 2.0% year-over-year gain from its recent pace of 1.7%. Profits should also grow at only a low-single-digit pace from a very elevated level, as corporations get squeezed by a steady rise in compensation and sluggish markets.

Finally, Washington will both impact and be impacted by the economy in 2020. Despite signs of de-escalation in the trade war, the threat of tariff hikes will likely remain through 2020, reducing exports, imports and investment spending. With regard to the 2020 U.S. elections, because of the early stacking of primaries, it should be easy to predict the Democratic nominee for president by March 17. Investors will be interested in this candidate's proposals on corporate taxation, regulation and health care.

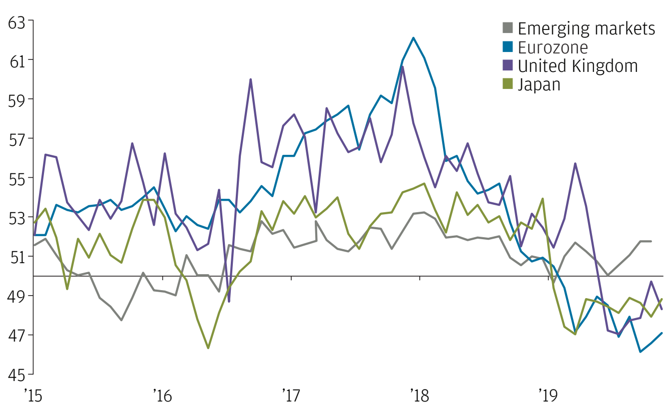
Much of the year will be spent handicapping the November election both with regard to the race for the presidency and control of Congress. A divided government is the most likely outcome. However, one party controlling the White House, the House of Representatives and the Senate could bring more radical policy change. Finally, fiscal 2020 will see the budget deficit exceed $1 trillion for the first time since 2012, and financing this deficit may put some extra strain on the bond market.

INTERNATIONAL ECONOMY: SOME IMPROVEMENT LIKELY AS TRADE TENSIONS EASE

International economies have been under pressure for almost two years, thanks largely to the impact of trade uncertainty on export volumes and capital spending. Manufacturing has felt the brunt of these effects, while services have held up much better alongside resilient labor markets. In response to the downshift in growth, many international central banks eased policy throughout 2019. Fiscal stimulus, meanwhile, has only really been deployed in emerging Asia, as other countries were either unable or unwilling to tap on the accelerator. The combination of broad monetary easing and more limited fiscal stimulus seen throughout 2019, as well as the expectation that the trade war will not escalate further, should permit global growth to stabilize and even shift slightly higher toward trend in 2020.

Early signs of stabilization in global manufacturing, but 2017-style reacceleration not expected

EXHIBIT 3: MANUFACTURING PMI OUTPUT INDEX



Source: Markit, J.P. Morgan Asset Management.

Data are as of November 26, 2019.

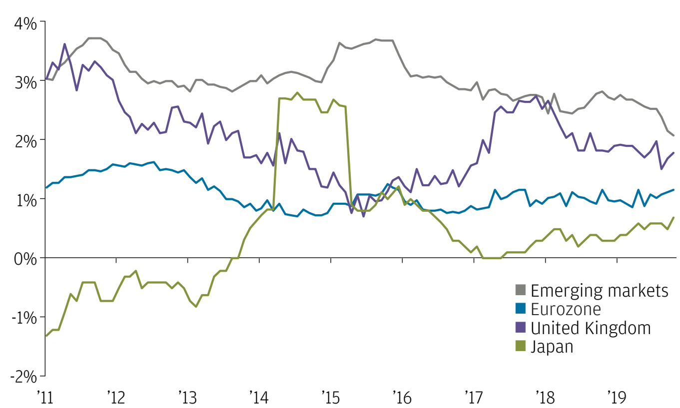
Among developed economies, lingering trade tensions between the United States and its trading partners have damaged the more export-oriented economies. In addition, the developed world faces additional policy uncertainties, including Brexit-related tensions, political instability in certain European countries and challenging demographics in Japan. While much of the uncertainty surrounding Brexit may finally be resolved in the year ahead, other sources of volatility will likely linger and new ones will, of course, emerge. Despite this, the rather cyclical nature of the manufacturing sector globally suggests that developed market (DM) growth may already have found a bottom.

Regardless, slow growth prospects should pressure DM central banks to continue to ease policy despite already holding benchmark rates in negative territory. Moreover, monetary easing has proven to be very ineffective in stimulating inflation in recent years, and we expect inflation to remain below target for most developed markets. Meaningful fiscal stimulus could, in theory, help to alleviate problems in slower growing economies like Germany and Japan, but that remains unlikely. As a result, while DM growth may improve next year, the improvement will likely be modest.

In emerging markets, the official political calendar is fairly empty in 2020. The most important issue remains the evolution of trade policy: no further trade shocks should permit EM Asian economies to stabilize, and overall EM inflation and interest rates to remain low. While China's economic growth may dip below 6% due to cyclical and structural factors, monetary and fiscal easing over the past 18 months should allow it to stabilize just below that pace. Future massive monetary easing or infrastructure spending is unlikely, given China's focus on sustainable growth. Instead, growth will be anchored by the consumer: the rise of China's middle class should continue to fuel demand for consumer goods and services. In Latin America, domestic policy remains, as usual, a key variable. Both Brazil and Mexico should see a significant pickup in growth compared to 2019, offsetting a continued recession in Argentina, and allowing the region to expand more strongly in 2020.

Inflation should remain low in both DM and EM countries

EXHIBIT 4: GLOBAL CORE INFLATION, YEAR-OVER-YEAR % CHANGE



Source: ECB, Ministry of Internal Affairs and Communications (Japan), Office for National Statistics (UK), J.P. Morgan Global Research, J.P. Morgan Asset Management.

Data are as of November 26, 2019.

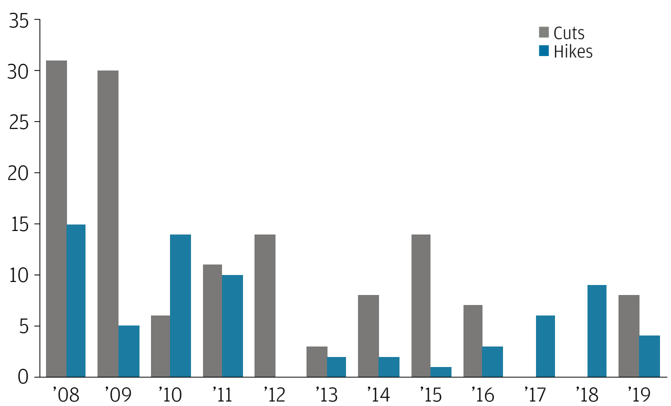
FIXED INCOME: LOW-YIELD INVESTING IN A HIGH-RISK WORLD

After a challenging 2018, fixed income investors caught a break in 2019: global central banks eased monetary policy in the face of weak global growth and muted inflation; the U.S. 10-year Treasury yield fell from 2.7% to 1.8% over the course of the year; and the U.S. Barclays Aggregate has returned 8.3% year-to-date, on track for its best year since 2002. So what does 2020 have in store for fixed income investors?

Central banks around the world re-entered easing mode in 2019, with the top-10 DM central banks cutting rates eight times collectively after two years of broad-based policy tightening, as seen in Exhibit 5. This U-turn in global monetary policy is exemplified by the European Central Bank (ECB) restarting asset purchases, after halting them in January 2019. If global economic growth remains soft in 2020, overseas central banks will likely remain in easing mode.

Central banks have cut rates as global growth has slowed

EXHIBIT 5: NUMBER OF RATE CHANGES BY TOP-10 DM CENTRAL BANKS



Source: Bloomberg, J.P. Morgan Asset Management. Central banks included are Australia, Canada, Denmark, eurozone, Japan, Norway, Sweden, Switzerland, UK and U.S.

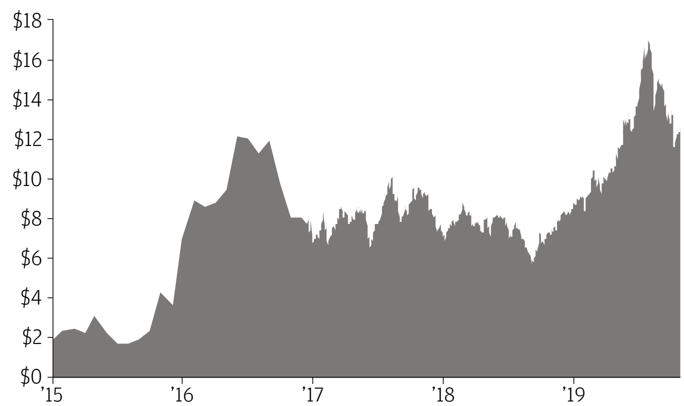
Data are as of November 26, 2019.

In the United States, the path forward for monetary policy is less clear. Robust U.S. consumer and labor market data likely justify a higher federal funds rate. Meanwhile, economic weakness abroad and heightened political tensions may warrant further cuts from the U.S. Federal Reserve (Fed). These opposing dynamics are reflected in the September 2019 Fed estimates, with roughly half the committee happy to see rates at current levels through the end of 2020 and half preferring a somewhat more hawkish policy. In our view, with sluggish global growth and global central banks in easing mode, the Fed will likely stay on pause until international economies stabilize. The Fed's determination to ignore political pressure in the face of administration criticism provides a further, though unstated, rationale for no policy change in an election year.

Around the world, loose monetary policy, sluggish growth and limited inflation could further inflate the negative-yielding bond bubble, which increased \$3.7 trillion in 2019 to \$12 trillion, as shown in Exhibit 6. This should put further downward pressure on the U.S. Treasury yield curve: at 2.30%, the 30-year U.S. Treasury bond yield is higher than all other DM government debt. U.S. Treasury debt, as a result, will continue to look like the best house in a bad neighborhood. Without a meaningful change in the global economic backdrop, it will be hard for yields to move materially higher in the near future. This stance favors longer duration fixed income.

Stock of negative-yielding debt could inflate further in 2020

EXHIBIT 6: NEGATIVE-YIELDING DEBT, USD TRILLIONS



Source: Bloomberg, J.P. Morgan Asset Management.

Data are as of November 26, 2019.

As the hunt for yield continues in a low-yield world, higher-yielding asset classes, including U.S. dollar-denominated EM debt and global high yield, may look attractive. However, investors should be mindful that with greater yield comes greater risk, and instead focus on quality and diversification: U.S. Treasuries, municipal debt and mortgage-backed securities continue to offer some yield and have downside protection. At this stage in the economic cycle, a continued focus on quality and downside protection seems an appropriate stance.

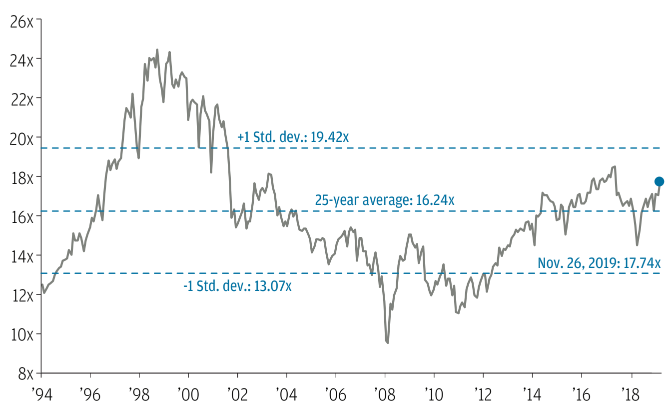
U.S. EQUITIES: LATE-CYCLE DEFENSE

On the surface, 2019 has been a solid year for the U.S. equity market, with the S&P 500 up over 25% through the middle of November. To an extent, this is a function of the starting point, as stocks sold off heavily into the end of 2018. That being said, equity markets have hit new all-time highs, as multiples have expanded on the back of waning geopolitical uncertainty and third quarter earnings that came in better than expected. Beneath the surface, however, the fundamentals are showing signs of deterioration – earnings growth has slowed, profit margins are under pressure and the pace of buybacks has come off the boil. As we look ahead to 2020, we foresee modest profit growth and a stock market that grinds higher, but downside risks are building.

The S&P 500's forward price to earnings ratio currently sits at around 17.5x, near the higher end of its recent range. With markets already pricing in material progress on trade, it is difficult to see how significant multiple expansion can continue. Given this expectation for range-bound valuations, earnings look set to be the main driver of returns next year.

S&P 500 Index: Forward P/E ratio

EXHIBIT 7: PRICE DIVIDED BY CONSENSUS ANALYST ESTIMATES FOR EARNINGS OVER THE NEXT 12 MONTHS



Source: FactSet, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management.

Price to earnings is price divided by consensus analyst estimates of earnings per share for the next 12 months as provided by IBES since November 1994, and FactSet for November 26, 2019. Average P/E and standard deviations are calculated using 25 years of IBES history.

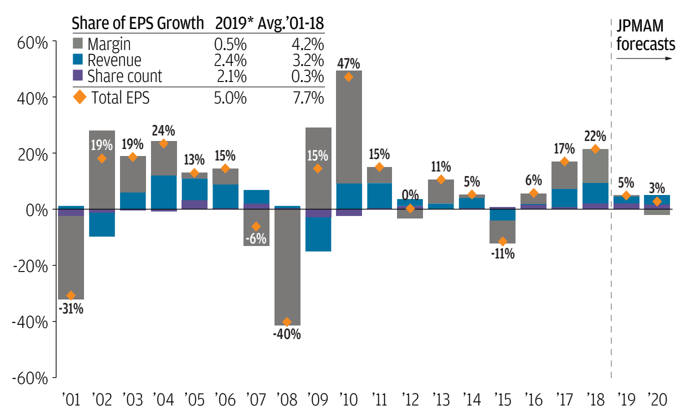
Data are as of November 26, 2019.

2019 has seen a slowdown in earnings growth, with margin contraction weighing on the headline figure. But what does this mean for earnings in 2020? The pace of buybacks has slowed, and it seems reasonable to expect this to continue next year. At the same time, revenue growth has been and will continue to be limited by low rates of inflation, trend-like U.S. economic growth and still slow growth overseas. Margins have been contracting throughout 2019, and are now nearly a percentage point lower than a year ago. Consensus estimates are for 9% earnings growth in 2020, driven by an assumption that profit margins will expand north of 12%. But given a backdrop characterized by low unemployment, modest wage growth and moderate revenue growth, it is difficult to see how this might materialize.

Consensus estimates will fall in the coming weeks. The question is, will they fall enough? Our top-down earnings model currently projects profit growth of around 1% next year under the assumption that profit margins fall to a level of 10.6% by the end of 2020. However, if we assume that margins are a bit more resilient, and hover around 11% over the course of the year, our forecast improves to 2.5%. Regardless, these numbers are well below consensus estimates, and the risks are tilted to the downside.

S&P 500 year-over-year operating EPS growth

EXHIBIT 8: ANNUAL GROWTH BROKEN INTO REVENUE, CHANGES IN PROFIT MARGIN & CHANGES IN SHARE COUNT



Source: Compustat, FactSet, Standard & Poor's, J.P. Morgan Asset Management.

EPS levels are based on annual operating earnings per share. *2019 & 2020 earnings are J.P. Morgan Asset Management forecasts. Percentages may not sum due to rounding. Past performance is not indicative of future returns.

Data are as of November 26, 2019.

Given a backdrop of sluggish, but positive, earnings growth, how should investors position equity portfolios? Volatility tends to be higher in election years than in non-election years, and we see no reason why 2020 should be any different. Given this, we continue to focus on quality and total yield (dividends + buybacks) in an effort to mute some of this projected volatility. This leads us to sectors such as technology, financials and energy, with the more value-oriented sectors also commanding a valuation advantage. On the other hand, defensive bond proxies continue to look expensive. With recession risk contained, we continue to balance cyclicality and yield, and believe a combination of the two will drive an optimal outcome for investors.

INTERNATIONAL EQUITIES: LESS OF A HEADWIND, BUT STILL A BUMPY RIDE

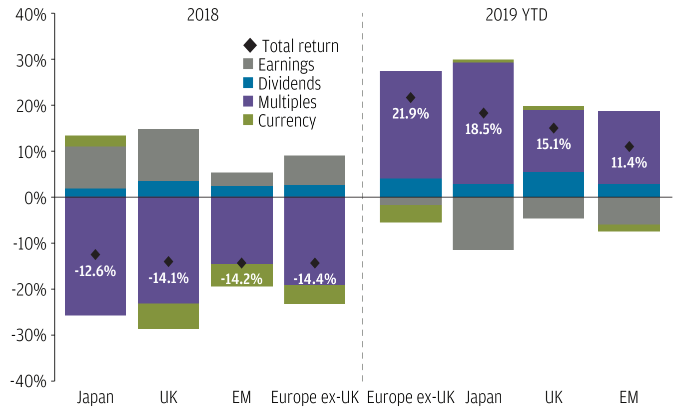
For U.S. investors, a view on international equities depends on three variables: the dollar, earnings growth and multiples.

Slower U.S. economic growth combined with more stable global growth should allow the dollar to stabilize if not fall in 2020. If this transpires, U.S.-based investors will avoid the currency headwind that has eaten into international returns in six of the last seven years, including 2019.

Beyond this, greater global economic stability should bolster international earnings expectations, halting the decline seen over the last 18 months; earnings should, therefore, be a neutral-to-positive factor for performance. And finally, multiples may expand a bit further, should the expected trade war truce continue to result in higher investor confidence. All told, international equities should move higher in 2020, but with the ongoing risk of occasional policy flare-ups, the road will likely remain bumpy.

2020 might be the year that all sources of returns contribute a bit to positive international returns

EXHIBIT 9: TOTAL RETURN, USD



Source: FactSet, MSCI, Standard & Poor's, J.P. Morgan Asset Management.

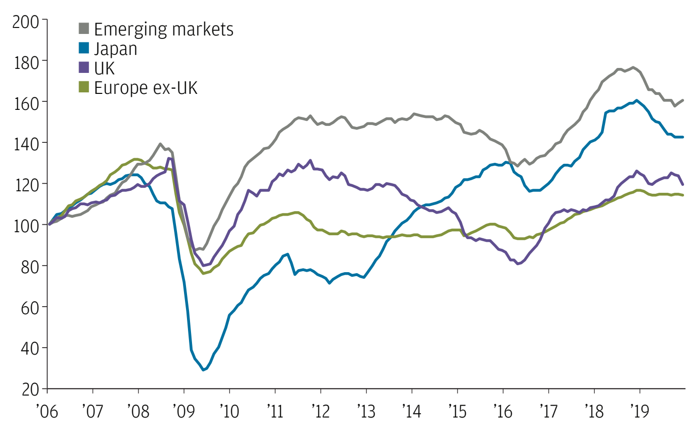
All return values are MSCI Gross Index (official) data. Multiple expansion is based on the forward P/E ratio, and EPS growth outlook is based on NTMA earnings estimates.

Chart is for illustrative purposes only. Past performance is not indicative of future results.

Data are as of November 26, 2019.

Global earnings expectations are slowly stabilizing

EXHIBIT 10: EPS, LOCAL CURRENCY, NEXT 12 MONTHS, JAN. 2006 = 100



Source: FactSet, MSCI, J.P. Morgan Asset Management.

Data are as of November 26, 2019.

In the long run, international equity markets should see improving economic conditions, rising interest rates and a more risk-on attitude among investors. As this materializes, the collective impact of stronger overseas earnings growth, a falling dollar and lower current valuations should allow international equities to outperform their U.S. counterparts. However, with developed international equity markets skewed more heavily toward cyclical sectors — financials, energy, industrials and consumer discretionary — and away from technology, short-term performance is closely linked to sentiment, which is exceedingly hard to forecast in the year ahead.

In addition, it is worth highlighting that international markets are, broadly speaking, somewhat inefficient, especially compared to the United States, in that analyst coverage is sparser. In such an environment, stock pickers (i.e., active management) do have the potential to add alpha, especially when focusing on companies that can capture positive global consumer trends. In short, while the equity market environment will not be easy in 2020, pockets of opportunity may exist. Moreover, with some developed economies in a more favorable cyclical position than the United States — see the eurozone unemployment rate — and stocks cheaply valued relative to history, long-term investors could still see developed international equity markets outperform the United States over a longer time horizon.

With the global economy stabilizing and trade escalation less likely, EM equity performance should be positive in absolute terms as these confidence variables add a bit to returns. In terms of fundamentals, emerging markets should be able to deliver double-digit earnings growth, as domestic companies remain resilient and export-reliant revenues rebound. As such, earnings expectations of 14% for next year look reasonable.

However, for EM equities even more than their DM counterparts, investor confidence is crucial in the short term as it leads to big swings in the multiple and in EM currencies versus the dollar. Because of this, investors should continue to focus on emerging markets for the long run. The opportunities remain centered on the emerging middle class theme, which should continue to positively impact firms in the EM consumer, financials, technology and health care sectors. Finally, it should be noted that many U.S. investors remain extremely underweight EM equities, increasing the importance of considering adding to this asset class as a way of boosting long-term returns.

INVESTING PRINCIPLES: UNCERTAIN TIMES ARE EXACTLY WHEN INVESTORS SHOULD STICK TO THE PLAN

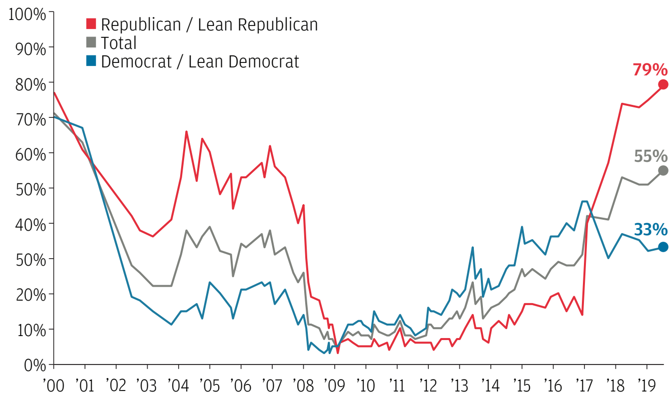
With 2020 poised to be a volatile year for markets dominated by political and geo-political risk in the United States and abroad, it is more important than ever for investors to adhere to tried and true investing principles. Although the U.S. economy has slowed down, there are still no signs of large imbalances or overheating that might indicate we are at the end of the expansion. Nevertheless, with the risk of a pullback, bear market and/or recession rising with every passing year, a need to stick to the plan becomes more evident.

While it feels natural to want to react to the news cycle and market volatility, the point of any financial plan (or asset allocation or Investment Policy Statement (IPS) etc.) is for moments and periods like this — when uncertainty is high and volatility seems set to rise. A clear example of this is in allocating to equities. Even with the bull market entering its 12th year, leading to an understandable instinct to hunker down in cash or reduce equity exposure, we still believe that equities are the return powerhouses within portfolios. Longer-run investors can afford to keep their allocations to equities and still put new money to work in a way tailored to late-cycle investing. For instance, consider equity sectors that garner a healthy portion of their return from shareholder yield (dividends + buybacks) versus capital appreciation, such as technology, financials and energy. Also, given the outperformance of the United States to most of the bull market, along with depressed valuations and higher dividend yields internationally, investors should consider at least getting back up to plan with their international equity allocations.

A key point to be made for investing in 2020 involves U.S. politics. Simply put — investors should not let politics impact investment decisions in their portfolios. It is well known that biases are often insidious factors impacting investor behavior. The first step is being aware: political affiliation does affect views on the economy as shown in Exhibit 11.

Consumer confidence by political affiliation

EXHIBIT 11: PERCENTAGE OF REPUBLICANS AND DEMOCRATS WHO RATE NATIONAL ECONOMIC CONDITIONS AS EXCELLENT OR GOOD



Source: Pew Research Center, J.P. Morgan Asset Management. Pew Research Center, July 2019, "Public's Views of Nation's Economy Remain Positive and Deeply Partisan." Question: Thinking about the nation's economy, How would you rate economic conditions in this country today… as excellent, good, only fair, or poor?

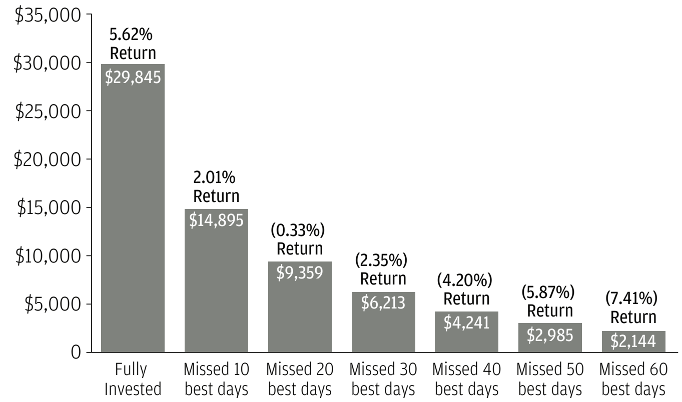
Data are as of November 26, 2019.

This fascinating data shows that while we are all looking at the same economy, that is the same GDP data, unemployment rate etc., we perceive it differently depending on our political affiliation. Interestingly, when times are bad we can all seem to agree on the state of the economy (as in 2009); however, right now the view varies greatly between Democrats and Republicans. It's not a stretch to infer that any politically amplified view on the state of the economy likely feeds into investment decisions through under- or over-allocation to risk assets and, in particular, equities and holdings of cash.

Moreover, timing the market around elections or any other market event requires investors to decide when to get out and when to get back in. Most critically, the impact of those well-intentioned but misguided activities tends to significantly hurt returns as we show in Exhibit 12.

Staying invested matters

EXHIBIT 12: RETURNS OF THE S&P 500; PERFORMANCE OF A $100,000 INVESTMENT BETWEEN JANUARY 4, 1999 AND DECEMBER 31, 2018



Source: Morningstar Direct, J.P. Morgan Asset Management.

Returns based on the S&P 500 Total Return Index.

For illustrative purposes only. Past performance is not indicative of future returns.

Data are as of November 26, 2019.

Within fixed income, we are adding duration and higher-quality positions within credit. The challenge for fixed income investors has been the already low coupons and the possibility they will continue to fall. This does not imply we abandon fixed income altogether — quite the contrary — even at low rates, high-quality duration provides the tried and true diversifier in a downturn. However, it does suggest we need to be creative in how we cobble together diverse and sustainable income streams for clients from equities, preferreds and alternatives.

Being diversified within the fixed income space as well as the broad portfolio makes sense. As we move closer to the next recession, volatility and uncertainty are likely to remain elevated. Having a well-thought-out plan and sticking to it through a diversified portfolio can prevent behavioral biases from taking hold and hurting returns.

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